Supreme Court, U.S.
FILED
AUG 19 2002
OFFICE OF THE CLERK

(5)

No. 01-1289

In the Supreme Court of the United States

STATE FARM MUTUAL AUTOMOBILE INSURANCE COMPANY,
Petitioner,

v.

CURTIS B. CAMPBELL ND INEZ PREECE CAMPBELL,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Utah Supreme Court

BRIEF *AMICUS CURIAE* OF A. MITCHELL POLINSKY, STEVEN SHAVELL, AND THE CITIZENS FOR A SOUND ECONOMY FOUNDATION IN SUPPORT OF PETITIONER

DAN M. KAHAN
Counsel of Record
P.O. Box 208215
Yale Station
New Haven, CT 06511
(203) 432-8832
Counsel for Amici Curiae

30pp

QUESTION PRESENTED

The *amici curiae* will address the following question:

Whether in relying on the probability that State Farm would escape liability for underpayment of first-party claims — rather than the probability that State Farm would escape liability for third-party bad faith — the Utah Supreme Court misapplied deterrence theory and thereby mistakenly approved an irrational and excessive punitive damages judgment.

TABLE OF CONTENTS

Page

QUESTION PRESENTED I

TABLE OF AUTHORITIES iv

INTEREST OF THE AMICI CURIAE 1

INTRODUCTION AND SUMMARY OF ARGUMENT 3

ARGUMENT 6

I. DETERRENCE THEORY SUPPLIES A REASONABLE CONSTRAINT ON PUNITIVE DAMAGE AWARDS. 7

A. Punitive Damages May Serve Deterrence Goals When Compensatory Damages Fail To Make An Injurer Pay The Full Costs Of The Harm It Imposes. 7

B. Punitive Damages That Exceed The Amount Necessary To Make An Injurer Pay The Cost Of The Harm It Imposes Impede Societal Well-Being. 10

C. Punitive Damages Should Be Based On The Specific Conduct For Which The Defendant Has Been Found Liable, Not On Different Conduct. 12

II. THE UTAH SUPREME COURT APPLIED DETERRENCE THEORY IN AN IRRATIONAL MANNER 14

TABLE OF CONTENTS – continued

Page

A. The Utah Supreme Court Failed To Consider Third-Party Claims Handling Practices Separately From First-Party Practices, And Thereby Exaggerated The Likelihood That State Farm's Conduct Would Escape Liability. 15

B. The Utah Supreme Court's Imposition Of Excessive Punitive Damages Will Result In Socially Excessive Increases In The Price Of Liability Insurance And The Possible Withdrawal Of Such Insurance From The Market. 22

CONCLUSION 24

TABLE OF AUTHORITIES

Page(s)

CASES

BMW of N. Am., Inc. v. *Gore*, 517 U.S. 559 (1996) 3, 4, 6, 10

Cairaole v. *New York*, 216 F.3d 236 (2d Cir. 2000) 4

Crookston v. *Fire Ins. Exch.*, 817 P. 2d 937 (1993). 14

Pacific Mut. Life Ins. Co. v. *Haslip*, 499 U.S. 1 (1991) 4, 6, 10

Perez v. *Z Frank Oldsmobile*, 223 F.3d 617 (7th Cir. 2000) 4

Zazu Designs v. *L'Oreal*, 979 F.2d 499 (7th Cir. 1992) 10

MISCELLANEOUS

Stephen S. Ashley, Bad Faith Actions (1996)..... 19

Battle Brews in Arkansas Over Nursing-Home Liability, BestWire, October 10, 2001 24

James Bauman, *Emotional Distress Damages and the Tort of Insurance Bad Faith*, 46 Drake L. Rev. 717 (1998) 19-20

Guido Calabresi, The Cost of Accidents (1970) 7

Don Dewees, David Duff & Michael Trebilcock, Exploring the *Domain* of Accident Law: Taking the Facts Seriously (1996)..... 11

Insurance Companies, Fearing Jury Verdicts, Shy Away from State, Associated Press State and Regional Wire, June 19, 2001..... 24

Daniel Kessler & Mark McClellan, *Do Doctors Practice Defensive Medicine?*, 111 Q.J. Econ. 353 (1996) 11

TABLE OF AUTHORITIES – continued

Page(s)

John C. McCarthy, Recovery of Damages for Bad Faith (5th ed. 1990) 19, 20-21

A. Mitchell Polinsky & Steven Shavell, *Punitive Damages: An Economic Analysis,* 111 Harv. L. Rev. 869 (1998) 7, 9-10, 18

Douglas R. Richmond, *An Overview of Insurance Bad Faith Law and Litigation*, 25 Seton Hall L. Rev. 74 (1994)..... 20

Steven Shavell, Economic Analysis of Accident Law (1987) 7

Alan O. Sykes, *"Bad Faith" Breach of Contract by First-Party Insurers*, 25 J. Legal Stud. 405 (1996). 18, 19

Kent D. Syverud, *The Duty to Settle*, 76 Va. L. Rev. 1113 (1980) 20

W. Kip Viscusi, Reforming Products Liability (1991) 11

BRIEF *AMICUS CURIAE* OF A. MITCHELL POLINSKY, STEVEN SHAVELL, AND THE CITIZENS FOR A SOUND ECONOMY FOUNDATION IN SUPPORT OF PETITIONER

INTEREST OF THE *AMICI CURIAE*[1]

A. Mitchell Polinsky is the Josephine Scott Crocker Professor of Law and Economics in the School of Law and a Professor of Economics by courtesy in the Department of Economics at Stanford University. He is also the Director of the John M. Olin Program in Law and Economics at Stanford Law School. Professor Polinsky has a PhD in Economics from MIT, a Master of Studies in Law degree from Yale Law School, has taught at the Department of Economics at Harvard University, and has been a professor of law and economics at Stanford since 1979. He is well known both nationally and internationally in the field of law and economics. His textbook, An Introduction to Law and Economics, has been used at over fifty law schools and economics departments in the United States and has been translated into Italian, Japanese, and Spanish. Professor Polinsky has written more than forty scholarly articles, mostly on the economic analysis of legal issues. He has served as President of the American Law and Economics Association, and has been both a Guggenheim Fellow and a Fellow of the Center for Advanced Study in the Behavioral Sciences at Stanford University. Professor Polinsky has applied the theory of deterrence — which is used in this brief — not only in his

---

[1] The parties have filed blanket written consents with the Clerk to the filing of *amicus* briefs in this case. This brief was not authored in whole or in part by counsel for a party, and no person or entity, other than the *amici curiae*, their members, and their counsel made a monetary contribution to the preparation and submission of this brief.

scholarship, but also in his private consulting work, for both plaintiffs and defendants.

Steven Shavell is the Samuel R. Rosenthal Professor of Law and Economics and the Director of the John M. Olin Center for Law, Economics, and Business, at Harvard Law School, as well as the Director of the Law and Economics Program of the National Bureau of Economic Research. Professor Shavell has a PhD in Economics from MIT, has taught at the Department of Economics at Harvard University, and has been a professor of law and economics at Harvard Law School since 1982. He is an internationally known scholar in economic analysis of legal issues and has worked extensively on tort law (he has published over 20 articles and a book in this area), as well as on insurance, litigation, and deterrence theory. He was recently President of the American Law and Economics Association, serves on many editorial boards, was elected to the American Academy of Arts and Sciences, and has been a Guggenheim Fellow. Professor Shavell also has applied deterrence theory in his private consulting work for both plaintiffs and defendants. Additionally, he has served as a consultant to government, including the Consumer Product Safety Commission, the Federal Trade Commission, the U.S. Department of Justice, and the U.S. Sentencing Commission.

Citizens for a Sound Economy Foundation ("CSE") is a nonprofit, nonpartisan organization with approximately 250,000 members. Its mission is to educate citizens on, and to promote the adoption of, free-market policies, which it believes inure to the benefit of consumers and citizens generally. CSE has taken an active part in public debate of antitrust enforcement, regulation of the Internet, deregulation of the telecommunications industry, and a host of other issues that affect the Nation's economy. CSE is vitally interested in assuring that tort liability, including punitive damages, is calibrated to promote rather than to frustrate free-market exchange.

INTRODUCTION AND SUMMARY OF ARGUMENT

The Utah Supreme Court's reinstatement of the punitive award in this case rested on a seemingly compelling premise: that "State Farm's actions, because of their clandestine nature, will be punished at most in one out of every 50,000 cases as a matter of statistical probability." Pet. App. 30a. It is widely understood that for deterrence purposes punitive damages should be increased in proportion to the likelihood that an injurer will escape liability. *See, e.g., BMW of N. Am., Inc. v. Gore*, 517 U.S. 559, 582 (1996) ("A higher ratio [of punitive to compensatory damages] may also be justified in cases in which the injury is hard to detect. . . ."). Accordingly, if the court correctly determined that State Farm faced only a very slight probability of having to pay damages in a case like this one, a high ratio of punitive to compensatory damages might have been warranted from a deterrence standpoint.

We submit, however, that the Utah Supreme Court determined the probability that State Farm would escape liability in an irrational manner. Rather than focus on the specific conduct deemed to have injured respondent Campbell — namely, State Farm's unreasonable rejection of an offer by a third-party to settle a suit against him — the court looked at a wide range of alleged conduct that had no bearing on Mr. Campbell's situation, including State Farm's allegedly wrongful underpayment of first-party insurance claims, a species of harmful behavior for which the prospect of suit is likely to be more remote. As a result, the court significantly underestimated the likelihood that State Farm would be found liable for the conduct at issue in this case, and thus significantly overestimated the size of the punitive award appropriate to deter such behavior.

We strongly support the use of deterrence theory to inform decisionmaking in punitive damages cases.[2] Punitive damages, this Court has made clear, satisfy Due Process only when awarded consistently with standards that "reasonabl[y] constrain[]" jury discretion, assure "meaningful and adequate review," and guarantee a "reasonable . . . and rational" relationship between the size of the award and the state's purpose in imposing it. *Pacific Mut. Life Ins. Co. v. Haslip*, 499 U.S. 1, 20-21 (1991); *see also BMW*, 517 U.S. at 587-94 (Breyer, J., concurring) (stressing "constitutional importance of legal standards" that "constrain[] arbitrary behavior and excessive awards"). It is our position that deterrence theory helps to supply such standards.

Of course, to usefully guide the imposition and review of punitive awards, deterrence theory must be properly applied. We believe that the manner in which the Utah Supreme Court determined the ratio between punitive and compensatory damages in this case was mistaken and would, if generalized, frustrate the ends that deterrence theory can help to achieve.

I. The theory of deterrence supplies a set of practical guidelines and principles that can be used to structure the imposition and review of punitive damages. Deterrence theory posits that actors will be deterred from conducting their affairs in a manner or to a degree that is socially undesirable as long as they are made to pay for the harms that their behavior

---

[2] *See, e.g., BMW*, 517 U.S. at 593 (Breyer, J., concurring) (summarizing "economic theories" of deterrence and suggesting that a "theory of that general kind might . . . provide[] a significant constraint on arbitrary awards" for purposes of Due Process); *Cairaole v. New York*, 216 F.3d 236, 244-45 (2d Cir. 2000) (Calabresi, J., concurring) (describing the theory in detail and using it to criticize exclusion of punitive damages from § 1983 actions); *Perez v. Z Frank Oldsmobile*, 223 F.3d 617, 621 (7th Cir. 2000) (describing the work of economist Gary Becker and using it to justify a reduction in a punitive award).

causes. Accordingly, if potential injurers can anticipate escaping liability for some fraction of the harm that their actions cause, they will not have an adequate incentive to reduce those harms.

Punitive damages are warranted, under deterrence theory, to remedy any shortfall between the harm an injurer causes and the compensatory damages that that party can be expected to pay across the run of cases in which it causes harm. It follows that the appropriate size of a punitive award can be determined by applying to the compensatory damages in any case in which an injurer is found liable a multiplier equal to the inverse of the likelihood that the injurer will be found liable for such behavior in general.

Any award larger than that is excessive. An award that exceeds the amount necessary to make the injurer pay for all the harm that its conduct imposes is not only unnecessary to give actors an incentive to carry out their activities in the manner and to the degree that most benefits society. It could also affirmatively detract from societal well-being by forcing parties to invest in precautions that cost more than they save in averted harm, or even lead parties to avoid socially desirable forms of behavior altogether.

To determine the appropriate size of punitive damages for different types of harm-producing conduct, it is essential to consider separately the likelihood that each type of conduct will give rise to liability. Otherwise, the punitive award will be too low or too high. For example, if a court bases a punitive award on conduct that is relatively unlikely to be detected in a case in which the conduct was in fact more likely to be discovered, it will end up imposing punitive damages for the latter conduct that systematically exceed the amount necessary to deter it.

II. The Utah Supreme Court applied deterrence theory in a manner that we believe to be irrational. In determining the likelihood that State Farm would be made to pay damages, it

examined not just the unreasonable refusal to settle third-party claims against its insureds — the conduct for which the company was found liable in this case — but also a diverse range of very different conduct. In particular, the court's conclusion that the likelihood of damages was only "one [in] 50,000" was based on testimony involving the wrongful underpayment of first-party insurance claims. Mishandling of first-party claims, however, is more likely to escape liability than is the wrongful rejection of settlement offers. By conflating the two forms of conduct the court significantly overestimated the appropriate ratio between punitive damages and compensatory damages necessary to deter the latter.

If the Utah Supreme Court's analysis is permitted to stand, it could well skew incentives of insurers to the ultimate detriment of insurance policyholders. By upholding excessive awards for the unreasonable rejection of settlement offers, the court's decision will put pressure on insurance carriers to accept unreasonably high settlement proposals, the cost of which will be passed on to insureds in the form of higher premiums. If enough insureds are unable or unwilling to pay these inflated rates, insurers may be forced to withdraw certain forms of liability insurance from the market altogether.

ARGUMENT

Because the Utah Supreme Court relied in part on deterrence considerations in this case, the theory of deterrence supplies one appropriate benchmark against which to measure the rationality of the court's decision. *See BMW*, 517 U.S. at 594 (Breyer, J., concurring) ("courts properly tend to judge the rationality of judicial actions in terms of the reasons that were given"). We begin, then, by summarizing the basic elements of deterrence, demonstrating that this theory can serve as an aid to furnishing the "reasonable constraints" on jury discretion and appellate review (*Haslip*, 499 U.S. at 20) that

due process demands.[3] We then explain our objection to the Utah Supreme Court's application of deterrence theory in this case.

I. DETERRENCE THEORY SUPPLIES A REASONABLE CONSTRAINT ON PUNITIVE DAMAGE AWARDS.

A. Punitive Damages May Serve Deterrence Goals When Compensatory Damages Fail To Make An Injurer Pay The Full Costs Of The Harm It Imposes.

The aim of tort law, from a deterrence point of view, is to prevent individuals and firms from carrying out their activities in a manner or to a degree that detracts from societal well-being. This objective can be accomplished, ordinarily, by making injurers liable for the harms that their activities cause, in which case they will have incentives to take reasonable precautions to avoid such harms or, if precautions are unavailing, to reduce or avoid the activities that cause them. *See generally* Guido Calabresi, The Cost of Accidents (1970); Steven Shavell, Economic Analysis of Accident Law (1987).

Consider, for example, a manufacturing plant that generates an emission that damages the finishes of automobiles in the vicinity of the plant. Damage to the automobiles is, say, $100,000, while a filter that would cost only $50,000 to install would completely prevent this damage. Because the manufacturer would rather pay $50,000 than $100,000, holding it liable for damages equal to the harm it causes will motivate it to install the filter. This is the socially desirable outcome.

---

[3] For a more complete exposition of the theory, we refer the Court to A. Mitchell Polinsky & Steven Shavell, *Punitive Damages: An Economic Analysis,* 111 Harv. L. Rev. 869 (1998).

Sometimes, however, liability for compensatory damages will fail to make an injurer pay the full costs of the harm it imposes. This is likely to be so, for example, when some of those who suffer harm do not realize that it is a result of another's acts (as opposed to bad luck, such as weather-induced damage to the finishes of automobiles), or when some fraction of those who know they have been harmed by another are unable to identify who caused the harm or to amass the evidence necessary to prove that a particular individual or firm caused it. Even if an injured party knows who caused the injury and can prove it, the cost of litigation may sometimes exceed the size of the harm, in which case the prospect of recovering compensatory damages will not furnish a sufficient incentive for that party to sue.

If an injurer can systematically escape liability for any of these reasons, it will not have an adequate incentive to take socially desirable precautions. A manufacturer that anticipated, for example, that relatively few automobile owners would realize that its plant's emissions caused the damage to their vehicles, or would bother to sue if they did, might expect to face, say, only $10,000 in damages. The manufacturer thus would not install a filter costing $50,000 even though the filter would avoid $100,000 in harm. Society would be worse off as a result.

It is in circumstances like these that punitive damages could be warranted under deterrence theory. By making an injurer pay an amount over and above compensatory damages, a punitive award can offset any shortfall between the injurer's expected compensatory liability and the harm it causes, thereby restoring its incentive to take reasonable precautions and to engage in potentially harmful activities to an appropriate degree.

Deterrence theory explains not only when punitive damages are justified, but also what size the punitive award should be. To erase the deficit between the compensatory

damages an injurer can be expected to incur and the magnitude of the harm its activities impose, punitive damages should be set at a level that makes the total damages equal to the product of the compensatory damages and the reciprocal of the probability that the injurer will be found liable when it ought to be.

To illustrate, suppose that the manufacturer in the previous example anticipates being held liable for only 1 in 5 automobiles damaged by the emissions, and that each automobile suffers an average of $1,000 in damage. In order to make the manufacturer pay the full cost of the harm from the emissions, the total damages (compensatory plus punitive) should equal $5,000 — $1,000 multiplied by 5 — each time the manufacturer is found liable. So if we assume that there were 100 automobiles regularly parked close enough to the plant to be damaged by the emission, we would expect 20 (that is, 1 in 5) automobile owners to sue, resulting in $100,000 (that is, 20 x $5,000) in total damages — an amount equal to the total harm to all of the automobiles (100 x $1,000).

For purposes of simplification, the preceding analysis omits certain adjustments that often are applicable. Notably, even if there is a shortfall between compensatory damages and harm, it may be appropriate to forgo a punitive award or to reduce its size if the potential victims are customers of the injurer, for then the injurer will be fearful of developing a bad reputation and losing current and future customers. This concern will tend to discourage a firm from selling shoddy or dangerous products or from providing unreliable services. There is also less warrant for punitive damages when other penalties, such as administrative or criminal sanctions, supplement compensatory remedies.[4] With the inclusion of these

---

[4]On the relevance to punitive damages under deterrence theory of these two factors — the reputational interest of firms and the possibility of public sanctions — see Polinsky & Shavell, *supra,* at

other factors in the analysis (when appropriate), deterrence theory supplies a tractable and appealing guide for both juries and courts to employ in determining punitive damages.

B. Punitive Damages That Exceed The Amount Necessary To Make An Injurer Pay The Cost Of The Harm It Imposes Impede Societal Well-Being.

Deterrence theory can be used to help satisfy the Due Process command that punitive damages be "reasonable in their amount and rational in light of their purpose." *Haslip*, 499 U.S. at 21; *see also BMW*, 517 U.S. at 584 (holding that a reviewing court cannot uphold a punitive award "to deter future misconduct without considering whether less drastic remedies could be expected to achieve that goal"). Making an injurer pay more than the full costs of the harm is not merely unnecessary to create adequate incentives to avoid unreasonably harmful behavior; it may also induce potential injurers to undertake socially wasteful precautions and to avoid socially desirable forms of behavior altogether.

Consider again the emissions example. But suppose now that a filter to eliminate the damage to the finishes of local

---

934-36, 926-27. Neither of the factors was taken into account by the Utah Supreme Court in its opinion in this case. There are also additional elements of the court's opinion that are problematic from the point of view of deterrence theory. Notably, there is little or no foundation in this theory for basing an award on the magnitude of a corporation's assets or "wealth," as the Utah Supreme Court did. *See* Polinsky & Shavell, *supra*, at 910-12; *see also Zazu Designs v. L'Oreal*, 979 F.2d 499, 508-90 (7th Cir. 1992). These aspects of the Utah Supreme Court's opinion, however, are not addressed in this brief (but see notes 10 and 14 below), which focuses on the probability of escaping liability and its relevance to determining punitive damages under deterrence theory.

automobiles would cost $500,000 instead of $50,000. In that case, if total liability (compensatory plus punitive) were at least $500,000 — an amount five times greater than the $100,000 harm — the manufacturer would be induced to install the filter.

That outcome, however, is contrary to society's interests. Society might insist that the manufacturer pay for the $100,000 total damage to the local vehicles as a means of assuring that those who are consuming the goods produced by the plant (the price of which would have to be increased to cover $100,000 in liability) are in fact realizing a benefit that exceeds the damage suffered by the automobile owners. But it would be wasteful to make the plant (and ultimately those who consume its products) pay for a filter that costs more than the harm that it is meant to prevent. Indeed, were the plant obliged to install the $500,000 filter to avoid the $100,000 loss to the automobile owners, it could be forced to cease production altogether, a result that might impose a bigger loss on its customers than that suffered by the automobile owners.

Although illustrated hypothetically, the societal costs associated with excessive liability can be quite real. Some scholars, for instance, attribute the phenomenon of "defensive medicine" — the use of tests and diagnostic procedures that cost more than their expected health benefits — to excessive damages in malpractice cases.[5] Liability awards are also thought to have been a factor in the withdrawal of socially valuable goods and services — including vaccines and private airplanes — from the market.[6] Wasteful precautions

---

[5] *See, e.g.*, Daniel Kessler & Mark McClellan, *Do Doctors Practice Defensive Medicine?*, 111 Q.J. Econ. 353 (1996).

[6] *See, e.g.*, Don Dewees, David Duff & Michael Trebilcock, Exploring the Domain of Accident Law: Taking the Facts Seriously 241-42 (1996) (vaccines); W. Kip Viscusi, Reforming Products Liability 8 (1991) (private airplanes).

and the chilling of socially desirable activities will result if liability is excessive — greater than that needed to make injurers pay for the harm their conduct causes.

C. Punitive Damages Should Be Based On The Specific Conduct For Which The Defendant Has Been Found Liable, Not On Different Conduct.

The theory of deterrence implies that juries and courts should impose punitive damages if and to the extent that compensatory liability alone fails to make an injurer pay the full cost of the harm its activity imposes. To implement this principle, it is important (for reasons explained below) that courts confine their and the jury's attention to the likelihood that the distinct form of injurious activity in question will escape liability. If instead a court conflates different forms of injurious activity — ones that have different likelihoods of escaping liability — the deterrence calculation will be skewed, resulting in punitive awards that fail to create proper incentives.

To illustrate, reconsider the emissions example. It was assumed that the manufacturer caused $1,000 in damages to each of 100 automobiles, and that it faced liability in 1 of 5 cases of harm. Using a multiplier of 5, the proper measure of total damages is $5,000 per case, resulting in $100,000 in total damages from the 20 expected suits, an amount equal to the total harm to all 100 automobiles.

Now imagine that the manufacturer also produces a second, distinct type of emission that causes $10,000 in property damage — say, blistered paint on neighborhood homes — and that the manufacturer is likely to incur liability 4 times in 5 when this harm occurs. Total damages in a case in which the manufacturer is sued for such a harm should equal $12,500 — $10,000 multiplied by 1.25 (that is, multiplied by a factor equal to 5 divided by 4). If, say, 100 local homes are damaged in total, 80 homeowners will sue, recovering $1,000,000 in total damages (80 x $12,500) — an amount

equal to the total harm associated with the second, home-damaging emission (100 x $10,000).

But now suppose that the court, instead of considering each type of emission separately, conflates evidence of the likelihood of liability for both types, perhaps on the theory that the manufacturer is engaged in a "pattern of similar misconduct" — emitting pollution — or that both types of emission stem from a "common plan to maximize company profits." If the court on that basis applies the multiplier associated with automobile-damaging emissions in cases involving house-damaging emissions, the court will impose an award of $50,000 (that is, 5 x $10,000) per house-damaging case and $4,000,000 (that is, 80 x $50,000) in total — an amount that is four times larger than necessary to make the manufacturer pay the cost of harm caused to all of the neighborhood homes. As a result, the plant will face an incentive to engage in excessive, wasteful precautions to control that emission, or may abandon the process that generates it altogether — to society's detriment.[7]

In sum, to apply deterrence analysis properly, a court should consider only the type of harm-producing conduct at issue in the case before it. Obviously, conduct can be classified according to many different criteria, including its type as a matter of linguistic convention ("pollution," "fraud," etc.)

---

[7] Other types of errors are also possible if the court lumps the two types of emissions together. For example, the court might apply the multiplier appropriate in cases involving the house-damaging emission to cases involving the automobile-damaging emission, generating insufficient damage awards in the latter type of case. Or the court might select a multiplier based on the average risk that the defendant will be found liable for either type of case. Then damages would be simultaneously excessive in home-emission cases and insufficient in automobile-emission cases. Litigants, of course, would try to induce the court to select the multiplier that most benefits their position.

or the goal for which an actor engages in it ("to profit," "to deceive," etc.). But for purposes of deterrence, *forms of harm-producing conduct should be considered separately to the extent that they involve differing likelihoods of generating liability*. This standard of individuation assures that the punitive damages multiplier will be set in a manner that gives parties proper incentives to control the risks of harm associated with their behavior.

II. THE UTAH SUPREME COURT APPLIED DETERRENCE THEORY IN AN IRRATIONAL MANNER.

Like other jurisdictions, Utah treats the contribution that a punitive damage award makes to deterrence as a factor in appellate review. *See Crookston v. Fire Ins. Exch.*, 817 P. 2d 937, 941 (1993). The Utah Supreme Court has emphasized, in particular, the appropriateness of imposing a punitive award many times larger than the compensatory award when "a company [can] predict that its systematic fraudulent conduct [will] evade detection in many instances," thereby making the prospect of damages "on those few occasions where it [is] discovered" an inadequate deterrent. *Id.*

The Utah Supreme Court relied on this factor in this case. Citing the plaintiffs' contention that "State Farm's actions, because of their clandestine nature, will be punished at most in one out of every 50,000 cases as a matter of statistical probability" (Pet. App. 30a), the court reinstated the $145 million punitive verdict returned by the jury.

We believe, however, that the Utah Supreme Court's analysis embodies a significant error. In determining the probability that State Farm's actions would escape liability, the court failed to focus on the specific form of misconduct engaged in by State Farm in the present case — the unreasonable rejection of a settlement offer in a case against one of its insureds — and instead focused on a much more diverse

range of alleged wrongs, including the purported underpayment of first-party claims by State Farm. Because these discrete forms of misconduct involve different likelihoods of generating liability, there is no foundation in deterrence theory for the court's conclusion that a very high ratio between punitive damages and compensatory damages was warranted in this case.

Indeed, if applied generally, the Utah Supreme Court's reasoning would lead to substantial distortions of companies' incentives to engage in care and to provide valued services, in the insurance industry and elsewhere. The court's analysis almost certainly caused it to significantly overestimate the likelihood that State Farm would escape liability for unreasonable rejection of settlement offers — and thus to overstate the size of the punitive award necessary to deter such behavior. Its judgment, if affirmed, would likely generate the adverse consequences associated with excessive damages awards. These include, in this setting, excessive pressure on insurers to accept high settlement demands, thereby increasing the premiums that they must charge for liability insurance, or possibly causing them to discontinue certain forms of liability insurance coverage altogether.

A. The Utah Supreme Court Failed To Consider Third-Party Claims Handling Practices Separately From First-Party Practices, And Thereby Exaggerated The Likelihood That State Farm's Conduct Would Escape Liability.

The high punitive award in this case rested on evidence of what the court characterized as a decades-long, "nationwide scheme" by State Farm "to meet corporate fiscal goals by capping payouts on claims company wide." Pet. App. 6a. Evidence of the alleged scheme included a diverse range of "dishonest and illicit practices" (Pet. App. 21a), from discrimination against minorities (Pet. App. 19a) to "mad dog defense tactics" (Pet. App. 19a) in suits against State Farm's

insureds. The core of the alleged plan, however, involved the systematic underpayment of first-party claims to company policyholders, particularly those who would be least "likely to object or take legal action" (Pet. App. 19a). Through directives embodied in an internal planning document known as the "Performance, Planning and Review" policy, State Farm, according to the trial court, "pressure[d] its adjusters to deny consumers insurance benefits" with the expectation that "few of its victims w[ould] even realize that they ha[d] been wronged," that "fewer still w[ould] ever be able to sue," and that "only a small fraction of those who d[id] sue w[ould] be able to weather the years of litigation needed to reach trial." Pet. App. 122a.

In determining the likelihood that State Farm would be held liable, however, neither the trial court nor the Utah Supreme Court distinguished among the various species of misconduct attributed to the "PP&R scheme." In particular, those courts did not distinguish between State Farm's wrongful denial of first-party claims filed by its own policyholders and the company's unreasonable rejection of settlement offers in cases against its policyholders — the type of "third-party claims handling" at issue in this case. The vast bulk of the evidence submitted in the punitive damages phase, including the evidence relating to the likelihood of escaping liability, concerned first-party claims handling.

Indeed, it was on the basis of testimony relating to the low probability of suit in the first-party context that the Utah Supreme Court concluded that State Farm would "likely be required to pay damages only once in 50,000 cases." Pet. App. 129a. This probability strikes us as implausibly low, and in fact is not supported by the record.[8] The critical point,

[8] That figure was suggested by respondents' appellate counsel (Br. of Appellees/Cross Appellants at 89), who apparently derived it from the testimony of a former State Farm claims adjustor. That witness testified that when State Farm underpaid first-party fire and automobile claims, "only 2 out of 10 [claimants] would actually come back and try to get more on their claims"; that "1 in 100" of the individuals who did not get satisfaction after complaining "would actually proceed to get an attorney and file a lawsuit"; and that "1 in 100 that filed a lawsuit would then make it to trial." 14 Tr. 107-08. If one multiplies .2 x .01 x .01, the result is .00002, or 1/50,000. Of course, insofar as "a lot of the 20 percent" who complained "actually g[o]t the right amount paid to them once they c[a]me back" (14 Tr. 108), and insofar as some fraction of the aggrieved claimants who hired lawyers but who did not go to trial presumably settled with the company for some amount, the idea that State Farm expected to be held accountable only once every 50,000 times that it undervalued a first-party claim is not actually supported by the record. Thus, not only is the court's finding unrelated to unreasonable denials of settlement demands in the third-party context, it is also of questionable reliability with respect to first-party claims.

however, is that the "1 in 50,000" likelihood relates to first-party and not third-party claims handling.

Instances of improper handling of first-party claims differ from instances of third-party bad faith in readily identifiable ways that affect the likelihood of suit. Not all first-party cases, of course, are of a piece.[9] But when the claim is for collision damage to an automobile or minor water damage to a home, for example, the size of the claim often will be relatively small. "[B]ecause the insured's litigation costs" are

[9] For example, when the first-party claimant is a firm or an individual who has insured an asset of especially high value, the likelihood of liability for mishandling a first-party claim is surely much higher than it is when the claimant is an individual seeking coverage for a small loss under an auto- or home-insurance policy. Suit is also more likely when an auto-insurance policyholder who has been injured in an accident is denied coverage for tens of thousands of dollars in medical expenses. It therefore makes sense to determine separately the likelihood of escaping liability for the mishandling of first-party claims in each of these contexts when considering the appropriateness of punitive damages.

thus likely to "exceed the expected award," the insurer might anticipate that the "insured will drop the matter and decline to file suit" if the company undervalues his or her claim. Alan O. Sykes, *"Bad Faith" Breach of Contract by First-Party Insurers*, 25 J. Legal Stud. 405, 413 (1996). Indeed, it is possible, in this context, that many individual policyholders will not "even realize that they have been wronged" (Pet. App. 122a), particularly if the insurer merely underpays their claims and does not reject them outright.[10]

The prospect that an insurer will escape liability when it engages in third-party bad faith, however, is likely to be much lower. The policyholder whose insurer has rejected an offer to settle within the policy limits will know as soon as the jury returns an excess verdict that he or she has suffered significant injury as a result of the insurer's conduct of the

[10] It does not necessarily follow, however, that because the risk of liability may be relatively low, punitive damages will routinely be warranted in cases of first-party claims mishandling. Because insurers and their insureds are in a market relationship, insurers face reputational incentives not to shortchange first-party claimants. *See generally* Polinsky & Shavell, *supra*, at 934-36. Individual policyholders, knowing that they will likely not be in a position to sue if mistreated, will be especially sensitive to companies' reputations when selecting auto- or home-insurance providers; if one company has a reputation for mistreating claimants during periods of distress, another that treats its insureds better will take the former's business away. *See* Sykes, *supra*, at 414 ("gains to the insurer from avoiding payment are small (because the claim is small), yet the reputational penalties" from such behavior may be significant). Because insurance firms thus risk inflicting a competitive injury on themselves if they systematically cheat their policyholders, they have an incentive to avoid wrongful denial of claims, even if the risk of suit were they to engage in such behavior would be relatively small.

litigation.[11] Moreover, unlike the harm to an individual denied full coverage for a flooded basement or a dented automobile side panel, the harm that Curtis Campbell would have suffered had he been required to pay the portion of the verdict in excess of the limits of his liability insurance would have been substantial — a full $136,000 above his policy limits. An insurance company is unlikely to assume that individuals who face losses of that magnitude will meekly "drop the matter and decline to file suit" (Sykes, 25 J. Legal Stud. at 413).

Because the stakes are high when verdicts substantially exceed policy limits (and become even higher in states such as Utah that authorize damages for emotional distress (*see* 1 John C. McCarthy,[12] Recovery of Damages for Bad Faith § 269 (5th ed. 1990)), insurance companies can anticipate that third-party bad-faith behavior on their part will often generate a considerable incentive for plaintiffs' lawyers to represent aggrieved insureds on a contingent-fee basis. Moreover, as this case illustrates, it is common practice for attorneys representing a plaintiff against an insurance company in a personal injury suit to lay the groundwork for a subsequent third-party bad-faith claim by the insured (represented by the same attorneys) by making an offer to "settle for the limit" of the insured's policy.[13]

[11] Because the insurer has a duty to advise the policyholder of any settlement proposals (*see* 1 John C. McCarthy, Recovery of Damages for Bad Faith § 229b (5th ed. 1990)), the insured will realize in the event of an excess verdict that the company previously rejected a policy-limits settlement offer.

[12] We note, for example, that in this case respondents were awarded attorneys fees and costs (Pet. App. 2a, 67a, 76a).

[13] *See, e.g.*, Stephen S. Ashley, Bad Faith Actions §§ 10.03-10.05 (1996) (pointing out that practice of "setting up" insurance companies began in third-party context and giving elaborate instructions on conducting the "set up"); James Bauman, *Emotional Distress*

There is nothing in the record suggesting that State Farm believed it could systematically reject reasonable settlement offers without risk of liability. The only evidence pertaining specifically to third-party bodily injury claims showed that State Farm settled or prevailed in over 90% of the 29,000 such claims filed against its insureds in Utah between 1980 and 1994 (28 Tr. 139-44). In all but one of the seven cases that resulted in excess verdicts during that period, the company either paid the excess verdict itself or settled on terms that protected its insureds from risk of execution on the judgment (21 Tr. 86-87, 88-89, 177-78; 30 Tr. 172, 185, 204). The one case in which it failed to do that — Campbell's — did result in litigation against, and liability for, State Farm.

This evidence suggests that a punitive-compensatory ratio even as high as 3:1, much less 145:1 (the ratio in this case) or 50,000:1, is not warranted according to deterrence theory. Of course, an insurance company like State Farm might sometimes not be found liable for having wrongfully rejected a settlement offer. This possibility is mitigated, however, because the law provides for devices, such as fee-shifting provisions (*see* 1 McCarthy, *supra*, § 270), which reduce impediments to suit, and liberal discovery rules (*see* 2

Damages and the Tort of Insurance Bad Faith, 46 Drake L. Rev. 717, 746 (1998) ("Knowledgeable plaintiff attorneys understand the need to 'set up' the liability insurer by making a policy limits demand, thereby triggering the insurer's duty to consider the interests of its insured."); Douglas R. Richmond, *An Overview of Insurance Bad Faith Law and Litigation*, 25 Seton Hall L. Rev. 74, 130 (1994) ("In recent years lecturers at continuing legal education seminars have given advice on how to 'set up' insurers for bad faith claims."); Kent D. Syverud, *The Duty to Settle*, 76 Va. L. Rev. 1113, 1169 (1980) (noting that plaintiffs "attempt to 'set up' insurers for excess liability claims under current duty-to-settle law").

McCarthy, *supra*, §§ 3.69-73), which facilitate proof of wrongdoing.[14]

All things considered, some amount of punitive damages might be warranted to remedy a shortfall between expected compensatory liability and the full harm imposed by third-party bad faith on the part of insurers. But because the Utah Supreme Court did not attempt to determine the likelihood that State Farm would escape liability for third-party bad faith — as opposed to mishandling of first-party claims and other alleged wrongs — its analysis does not support a punitive award as large as the one in this case in terms of deterrence principles.

The Utah Supreme Court rejected State Farm's objection to the scope of Campbell's punitive damages proof on the ground that the alleged wrongful underpayment of first-party claims and alleged unreasonable refusal to settle third-party ones — not to mention the variety of other wrongs attributed to State Farm — were part of a single "pattern of 'trickery and deceit' " (Pet. App. 20a) and were "motivated by" the single "goal of making profit by any means necessary" (Pet. App. 22a). *See also* Pet. App. 119a (trial court finding that "PP&R program . . . applied equally to the handling of both third-party and first-party claims"). Regardless of the validity of this conclusion, it does not justify treating instances of first-party claims underpayment and unreasonable rejection of third-party settlement offers as a single form of conduct in determining the proper ratio of punitive to compensatory damages. The reason, as we have emphasized, is simple: these two species of harmful behavior do not involve the same likelihood of escaping liability.

---

[14] Moreover, because companies like State Farm are in a market relationship with their liability insurance policyholders, market pressures will substantially augment their legal incentive to accept fair settlement demands.

The strong desirability of disaggregating different forms of harmful conduct for the purpose of determining the chance of escaping liability is underscored by the manipulation that might otherwise result in the litigation process. Generic labels such as "fraud" and "deceit" can be used to encompass a nearly limitless range of diverse wrongs. Likewise, the "goal" of "maximizing profit" fails to supply a test for differentiating between any of the actions — wrongful or not — that a commercial entity undertakes. Resourceful litigants, then, will manipulate categories such as these to characterize a defendant's wrongdoing in a manner that either exaggerates or suppresses the likelihood of liability, leaving courts with no principled means for setting the ratio between punitive and compensatory damages for deterrence purposes.

B. The Utah Supreme Court's Imposition Of Excessive Punitive Damages Will Result In Socially Excessive Increases In The Price Of Liability Insurance And The Possible Withdrawal Of Such Insurance From The Market.

As previously explained (*see* I.C., *supra*), the failure to consider distinct forms of injurious behavior separately in determining the punitive-compensatory ratio distorts incentives to engage in reasonable care. The Utah Supreme Court's conflation of State Farm's handling of first-party claims with its unreasonable rejection of settlement offers can be expected to have this effect.

Because instances of first-party claims mishandling are less likely to generate liability than are instances of third-party bad faith, the court's focus on the former plainly overstated the likelihood that third-party claims would escape liability. Setting punitive awards on the basis of such an overestimation, then, will result in insurers having to pay damages for such behavior that exceed the harm associated with wrongful rejections of settlement offers.

As a result, insurers will face incentives to take what are, in effect, excessive or wasteful precautions against excess verdicts. To avoid the risk of a large punitive award, for example, insurers are more likely to cave in to unreasonable offers, the cost of which will be reflected in premium increases that will chill the sale of insurance.

To illustrate, suppose that an insured is being sued for $200,000 and that the insurer (reasonably) believes that the risk that the plaintiff will prevail and be found entitled to that level of damages is 10%. The insured's expected liability therefore is $20,000 (that is, 0.1 x $200,000), making it reasonable to accept a settlement offer of that amount but not much more.

Suppose, though, that the plaintiff demands $50,000, the limit of the insured's policy. If the insurer believes that a court in a subsequent third-party bad-faith action would apply an unduly large punitive-damages multiplier — say, 100 — to any compensatory award equal to the excess verdict, it could face exposure of $15 million in punitive damages (that is, 100 times the difference between a $200,000 judgment and the $50,000 policy limit). Under these circumstances, the insurer would be likely to accept the plaintiff's unreasonable policy-limits settlement offer of $50,000. Moreover, because the insurer can anticipate this type of outcome, it would be forced to charge its insureds a premium consistent with the insurer having to frequently settle third-party claims for more than they are worth.

Excessive punitive awards for third-party bad-faith claims are also likely to induce insurers to invest more to monitor their employees — perhaps hiring two lawyers for a case for which they otherwise would have hired only one — in order to be confident that what seems like a reasonable rejection of a settlement offer will not in fact expose them to significant punitive liability. This form of wasteful precaution will also increase premiums for liability insurance.

Many insureds might be unwilling or unable to pay for premiums inflated as a result of the effects of excessive punitive damage awards. Consequently, certain forms of liability insurance may not be economical for insurers to provide.[15] This is, of course, the mechanism by which punitive damages are thought to have suppressed the provision of some socially valuable goods and services.

CONCLUSION

The judgment of the Supreme Court of Utah should be reversed.

Respectfully submitted.

DAN M. KAHAN
Counsel of Record
P.O. Box 208215
Yale Station
New Haven, CT 06511
(203) 432-8832

Counsel for Amici Curiae

AUGUST 2002

---

[15] *Cf. Insurance Companies, Fearing Jury Verdicts, Shy Away from State*, Associated Press State and Regional Wire, June 19, 2001 (noting that over 40 insurers doing business in Mississippi have stopped selling certain kinds of insurance or pulled out of the state entirely as a response to excessive jury verdicts); *Battle Brews in Arkansas Over Nursing-Home Liability*, BestWire, October 10, 2001 (because of lack of civil justice reform in the state, only 2 of more than 80 insurers that have authority to write liability policies for nursing homes in Arkansas are doing so, and both are either not accepting renewals or accepting them only selectively).